BusinessWeek

Prognosis: Mild Recession, Slow Recovery

By James C. Cooper
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The gathering weakness in the economy has reached the point where payrolls are shrinking. In the past that has always been a clear sign that a recession has begun. Given the growing pressures on consumers, the relentless slump in housing, and the spreading impact of the credit crunch, more losses in jobs and overall economic activity will surely follow. The question is: How bad will it get? Will the downturn be long and deep, like the 16-month recessions in 1973-75 and 1981-82, or short and shallow, like the eight-month episodes in 1990-91 and 2001?

While scary scenarios abound, as they did during the savings and loan crisis in the 1980s and '90s and the tech stock collapse in 2000, there are many reasons to forecast a mild recession this time, too. However, as was true in those two business cycles, don't expect a strong or rapid recovery given the depth of problems in housing and the credit markets.

In broad terms, recessions have been less virulent because structural changes, such as deregulation of markets, globalization of trade and capital flows, technology, and better management, especially of inventories, have improved efficiency and helped soften the blow from shocks. Most important, monetary and fiscal policies have been more responsive and often preemptive.

Factors unique to this business cycle will help. Outside of the finance sector, companies have expanded with unusual caution, leaving them lean. Since the last recession, inflation-adjusted investment in new buildings and equipment has grown at a 3.8% annual rate, and monthly gains in private-sector payrolls have averaged 75,000 workers. Despite strong overall growth, both are the slowest recovery paces since World War II. Businesses don't have excess production capacity, bloated payrolls, or top-heavy inventories requiring big cuts in capital spending, payrolls, and production.

Labor Dept. data show job growth is slipping more because companies have stopped hiring than because they are laying off existing employees. Also, the larger role of foreign trade will be a big plus. Growth abroad will slow but remain stronger than in the U.S. That, and the lower dollar, will lift exports and limit imports, supporting both capital spending and overall growth.

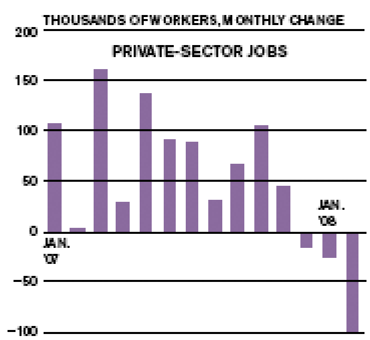
Past prudence also has left nonfinancial companies with solid balance sheets. In the fourth quarter the ratio of credit market debt to net worth was at a two-decade low, while the ratio of liquid assets to short-term debt was historically high. Despite last quarter's tighter credit conditions, corporate borrowing remained strong, rising at a 12.3% annual rate, helped notably by foreign lending. Companies also repurchased their stock and paid out dividends, both at record levels, hardly a picture of corporate retrenchment.

The short-and-shallow scenario depends crucially on an easing of credit market stress, which itself requires an expectation that home prices and mortgage failures will stabilize. Washington policy actions, especially from the Federal Reserve, are helping to promote that stabilization.

The Fed is attacking on two fronts: It continues to create innovative ways to pump liquidity into the credit markets, including the $200 billion Term Securities Lending Facility unveiled on Mar. 11. Also, its rate cuts are especially suited to helping housing, the economy's most interest-sensitive sector. Lower rates boost demand by cutting monthly payments while reducing the risk of mortgage default by facilitating refinancing and by easing the burden of rate resets on adjustable mortgages.

In the last two recessions, Fed policy was wrongly feared to be pushing on a string. That will be the case this time, too. But the Fed's efforts on housing will be an integral part of mitigating the downturn. Those actions most likely will need help from other public policy measures; Fed Chairman Ben Bernanke already suggested as much in a speech on Mar. 4. But given policy actions, corporate prudence, and structural changes that have moderated the business cycle, a 2008 recession should be short-lived.

FALLING PAYROLLS ARE SIGNALING A RECESSION



Data: Bureau of Labor Statistics, Global Insight